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Financial Crisis, Skyline Frankfurt

Breaking the cycle of crisis

Checking balance sheets and minimizing risks: Europe is addressing the financial and debt crisis with a banking union.

January 16, 2014 by Philip Plickert

Five years after the beginning of the financial crisis in autumn 2008 Europe is still facing difficulties. One of the reasons why the crisis has remained so intractable is because the problems of banks and governments are closely linked. A vicious circle emerged at the height of the **euro** crisis: ailing banks were rescued with public funds and this increased the sovereign debt of the crisis countries; this led to mistrust in financial markets and a decline in the price of government bonds, which in turn increased the pressure on bank balance sheets. As a result, the financial crisis became deeper and deeper – until Mario Draghi, the President of the European Central Bank (ECB), calmed the markets with his July 2012 pledge to retain the **euro** whatever the price. It is clear, however, that the announced programme of bond purchases has only eliminated some of the symptoms of the crisis.

Politicians and central bankers meanwhile openly admit that Europe delayed the resolution of the banking crisis. The market distrusts the banks, which have too many bad debts hidden on their books. According to a recent study by the Ernst & Young business consultancy, the proportion of loans that cannot be paid back at all or on time has reached a record level of 7.8% – amounting to a total value of 940 billion euros. The study says that the most bad loans are held by banks in Spain (12%) and Italy (11.5%) and the least by banks in Germany (3.2%). Many crisis-ridden banks are practically no longer able to issue loans.

Now, however, Europe has launched a project to clear up the mess: the banking union. It is also intended to support the troubled **euro** monetary union. “Monetary union needs banking union, not least because a stable banking sector is an essential complement to a sound money,” explains ECB Director Yves Mersch of Luxembourg. The new financial **architecture** is to have three pillars: first, a system of common banking supervision; second, a uniform resolution

system for unviable banks; and third, a Europe-wide deposit guarantee system. Each of these three elements is the subject of hefty debate. There is strong resistance to a common deposit guarantee system. Preparations for a common system of banking supervision have so far made the greatest progress, and at the end of the year EU heads of state and government reached agreement on a Single Resolution Mechanism.

Policymakers hope a stable banking union **architecture** will repair the weaknesses in the monetary union. The first task will involve ferreting out the toxic burdens in the financial sector. Weak banks must then be recapitalized, and unrescuable banks wound down. The first step in this process is a comprehensive audit of 128 major banks by the ECB, which began in November 2013. Sabine Lautenschläger, the Deputy President of the German Bundesbank who has been nominated as a member of the ECB Executive Board, emphasizes the importance of this audit: “With it, we wish above all to create transparency and expose any possible burdens left over from the past.” She says this is the only way of rebuilding trust and ruling out “the current general suspicion of weak bank balance sheets”.

The exercise consists of several stages. The first involves identifying the most toxic portfolios in individual banks. These can be property loans in Spain, for example, while the books of some state banks and the Commerzbank in Germany contain a large number of dubious ship loans. As a next step, the ECB auditors will examine these items in terms of their intrinsic value. In addition to this, the European Banking Authority (EBA) will be carrying out a stress test in 2014. This will involve a simulation of a banking crisis with bank losses. After the test, banks will have to be able to show they have an adequate cushion of funds available: a core-capital ratio of at least 8%. That is a little higher than the level required in the Basel III rules approved by the G20 countries. The results of the balance sheet and stress tests will be announced in October 2014.

The situation could become awkward for some banks. If capital shortfalls emerge, banks are meant to obtain the required capital primarily from investors. EU finance ministers have agreed a “liability cascade” for future bank rescues: first, shareholders and creditors as well as owners of large accounts with more than 100,000 euros are to fill the gap – in other words, a “bail-in” by investors rather than a “bail-out” by taxpayers. Only then, in second place, are national governments to support ailing banks. ECB Director Mersch emphasizes: “The banking union is not a transfer union by the back door. Everyone has to deal with their own legacy problems.” The bail-in rules will apply to future bank crises. However, they will only come into effect in 2016, one year after the beginning of banking supervision.

There are worries within the ECB about what happens if private and national funds are insufficient for a recapitalization of banks. Feelings of insecurity could make investors stingy with fresh capital. And the budgets of some highly indebted crisis countries would perhaps become overstretched by the need to find new injections of capital. That is why the Central Bank would like to see a European backstop. The European Stability Mechanism (ESM) would be a possible money lender here. Especially in Germany, however, that would again give rise to concerns about a European socialization of bank problems.

Europe is clearly divided on this issue. In the southern European countries that have been particularly hard hit by the crisis – for example, Spain and Italy, but also France – many people would like to see recapitalization financed by a European source like the ESM. In Germany, on the other hand, this idea has raised protests from many economists. The political parties in **Berlin** are still reeling from the shock they received when Alternative for Germany (AfD), a new **euro**-critical party, almost gained enough votes to enter parliament. Following the decisions of EU heads of state and government at the end of 2013, in which Germany asserted central demands, but also made concessions, there will now be a phased communitization of national resolution funds. After ten years the total sum available to pay for the closure of ailing banks is to reach 55 billion euros. However, many economists remain sceptical about whether this amount is sufficient to deal with a major bank crisis. ▀

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